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PARTNERS

Investment Research

Setting Your Investment Goals
It's Harder Than You Think

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How will you define "success" for your investment portfolio?

Sometimes we find ourselves sitting across the table from a private investor who describes his or her investment goal something like this:

> "My goal is to always have my investment capital with "top-performing" managers – the top 25% of all managers making similar investments. I want to earn the highest possible return for the amount of risk I am taking. If a manager falls out of the top group for two quarters in a row, I want to fire that manager and find another top-performer to replace him or her."

What is wrong with this? The statement tells us nothing about what the investor's financial needs are. It provides no information about how much investment capital is required, when and why it is needed, and how it will be used. It tells us nothing about the types and amount of various investment risks the investor can or should tolerate, and why. In addition, this investor plans to rely upon recent past performance to determine manager selection. The investor seems to be unaware of the numerous studies showing that a manager's past investment performance tells us little or nothing about that manager's future investment performance. A top-performing manager in any period has about the same probability in the next period of winding up in the worst-performing group as any other manager. Pursuing the above goal is likely to result in a high rate of manager turnover, which will result in unnecessary taxes and trading costs. The most likely outcome is very poor investment performance, especially when results are measured net of all fees, taxes, and trading costs.

What is the right way to define your investment goals?

The right way to define your investment goals requires you to answer many important questions about your financial situation now, and your expectations for the future. You must address the types and amounts of investment risks you are willing to tolerate. You must also consider taxes on your investment income, inflation, investment fees, regulatory constraints and legal constraints that apply to your situation.

The following is a list of questions that will help you to properly define your investment goals, along with an explanation of the considerations that apply to each question.

1. Why do you need to invest and accumulate capital – that is, for what purpose?

A. How much capital do you need?

B. When do you need it?

C. How does the amount you need to accumulate change in response to inflation?

D. What are you going to do with the capital after you accumulate it? Spend it all at once (for example, to purchase a vacation home)? Spend it down over a relatively short time period (for example, to pay school tuitions)? Draw upon it for income at regular intervals over a long period of time (for example, to fund your retirement)?

E. What will be the consequences for you if the money is not there when you need it?

F. What is your required rate of return, net of all fees, taxes to realize your goal? (This question should also be answered taking inflation into account. Please see explanation below.)

These questions define your need for money in the future. Questions A – C define the amount of capital you need. But, investment capital is not the same thing as spendable money. To convert investment capital into spendable money, you will probably have to pay taxes, you may have to pay fees (e.g. real estate sales commissions), and you may experience a loss of value. If your investment assets are not readily marketable (for example, real estate, a privately owned business, or private investment funds) there may be a substantial gap between the value you imagined the asset would bring you and what you can actually realize in a cash transaction.

Questions D and E are crucial to defining your investment goals because they relate to both the timing of your withdrawals and the consequences of a shortfall with respect to your goal. For example, a portfolio intended to fund four years of college tuitions starting 10 years from today must be constructed very differently than a portfolio that is intended to fund your retirement income over your remaining lifespan and starting decades from now. In the latter case, a shortfall can be more easily tolerated through a slight delay in your retirement date, working part time during retirement, or through an adjustment to your retirement income.

The answer to Question F can become your personal investment performance benchmark. Rather than using an abstract market benchmark such as the S&P 500 Stock Index as your benchmark, why not use a benchmark that actually relates to something important to you? So long as your average annual return is greater than or equal to your personal benchmark, you are on course to meet your financial requirements. If you decide to aim for higher returns – which means taking on additional risk exposures – you can do so, but you will know that you don't have to do that.

2. What is your forecast of the timing and amount of additions to your portfolio?

A. How much will you add to your portfolio?

B. When are the additions likely to occur—all at once, or in increments over time?

C. How much confidence do you have in your forecast?

D. Do you intend to borrow to raise cash to contribute to your portfolio? If so, how much? What collateral will secure the debt? What terms and conditions will apply to the debt?

The earlier money is invested, the greater the potential benefits an investor may realize from compound growth. Also, there is a direct relationship between the size of contributions to the portfolio vs. the amount of capital the investor needs to accumulate. If contributions are relatively large compared to the accumulation goal, the investor has a broader choice of portfolio constructions that are likely to meet the goal.

Conversely, if contributions are relatively small compared to the accumulation goal, the investor's choices will be constrained to a smaller range of risky portfolios that might meet the goal, but all of which may also have a high risk of failing to meet the goal.

A portfolio that receives regular and substantial contributions over an extended timeframe is easier to manage, is likely to produce better results on a risk-adjusted basis, and is likely be more tax-efficient than a portfolio that does not receive regular additions. That is because the steady inflow of new money addresses two key portfolio management needs: (1) a source of cash to take advantage of market corrections that create buying opportunities, and (2) portfolio rebalancing without triggering any taxes.

When a private investor decides to borrow money to enhance the size of his or her investment portfolio, the investor is simultaneously deciding to substantially increase his or her exposure to the risk of portfolio losses. We generally do not recommend borrowing. However, there is a role for debt in some types of private investments, such as hedge funds and private equity funds. We view that type of debt differently than debt taken on directly by private investors solely for the purpose of increasing the size if their portfolios.

3. What type of investment return do you need? How will the type of return you need change over time?

Investment returns can take any of the following forms:

- Income;
- Capital appreciation; or
- Any combination of income and capital appreciation.

The manner in which the investment return is earned relates to the types of assets it is appropriate for you to hold, the range of returns available from those assets, and your risk exposures. For example, if you need reliable and steady current cash flow from your investments, then some portion of your capital must be invested in assets that produce that type of income. That might include: bonds, stocks that pay dividends, income-producing real estate, and natural resource investments that produce income.

To take another example, high quality bonds produce steady and reliable current income, but the rate of return is usually quite low compared to other assets with less predictable returns. The "price" you pay for predictability is a low return.

Of course, you could try to boost your current income by purchasing high-yield bonds (a.k.a "junk bonds"), but you may be signing up for a much higher level of risk than you intended. "Risk" in this case means both a loss of income and a loss of some of your investment capital. It may also mean that the bonds you hold may not be readily saleable if you try to limit your losses by selling them when the market is under duress.

On the other hand, if you are investing to accumulate assets for retirement which is 20 years away, and you don't need any current income from your portfolio, you have a much broader choice of ways to allocate your capital assets that might be suitable. (The process of allocating your capital is referred to as asset allocation.) In any case, your choice of assets should be based on these key factors:

- Your investment time horizon;

- Your risk-carrying capacity;
- Your income tax parameters; and
- Legal or policy restrictions that apply to your situation.

We will discuss each of these factors in turn.

What is your investment time horizon? "Investment time horizon" is the timeframe over which about one-half of the value of your investment portfolio will be withdrawn. For example, a §529 plan to fund four years of college starting five years from today has a time horizon of about seven years. A retirement plan for someone age 50 who will retire at age 70 and might live to be 95 or 100, and who has other sources of income, has at least a 40 year time horizon. Note that for retirement income, the time horizon is based on your potential lifespan, not the life expectancy of those in your age group. At life expectancy, 50% of the members of age group are still alive. You won't be very happy if you live too long and run out of money!

Time horizon matters because it informs us about your capacity for carrying various types of investment risk. Your capacity for carrying risk determines the range of asset allocations that are appropriate for your situation. Those factors, in combination, determine the range of investment returns you can expect – they create the boundaries within which your expected returns lie, as shown in Figure 1.

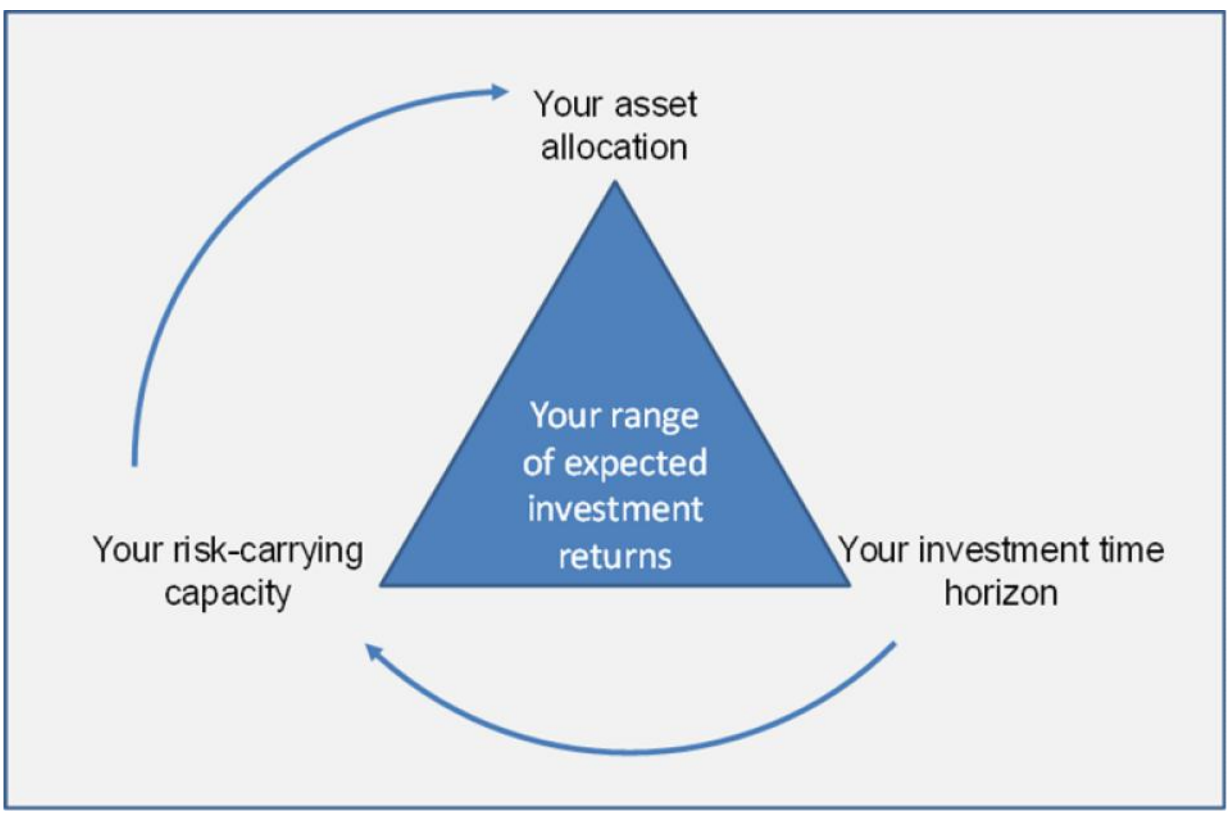
4. What is your risk-carrying capacity?

A. What risk exposures are you willing to accept? Why?

B. What risk exposures do you wish to avoid? Why?

Assessing your risk-carrying capacity requires both a comprehensive analysis of your financial situation and an assessment of your emotional tolerance for losses in your investment portfolio. While financial analysis plays an important role, sound judgment is

Figure 1



essential. Assessing your risk-carrying capacity is far too complex to be trusted to a simplistic questionnaire, or reduced to the standard Wall Street categories of "conservative", "moderate" or "aggressive". Those terms seem meaningless to us. Yet, that is the extent of most efforts to analyze risk-carrying capacity.

There are well over a dozen different types of investment risks. You need to understand your risk-carrying capacity with respect to each major type of risk. The relative importance of each type of risk will vary from one investor to another, depending upon the financial situation and willingness to risk loss of capital of each investor. Some of the major types of investment risk include: loss of your capital, difficulty finding a buyer when you wish to sell (liquidity risk), interest rate risk, and currency risk.

There is an inverse relationship between the expected return of an investment and the level of uncertainty about what the return will actually be. In general, the higher the return you strive to earn, the less certain you will be at the outset that you will actually earn your desired return. You may instead experience a loss, or a positive return much less than your target. Guaranteed returns are highly valued by investors, so investors are willing to pay a high price to get a guaranteed return. Therefore the return you can earn on those investments is very low. The "price" an investor must pay to have the opportunity to earn a higher return than the guaranteed return is uncertainty about what the actual return will be, including the risk of losing money.

Your risk-carrying capacity will change over time due to changes in your financial situation and your investment experience. There is a strong experiential component to your risk-carrying capacity, and it has an important feedback loop. For example, you may decide that you can tolerate a 15% loss of portfolio value in a single year. But, what if shortly after you start investing your portfolio suffers a 10% loss due to market conditions? Are you still able to tolerate a 15% the next year, and the next? The cumulative impact of these losses may take you far outside your comfort zone, causing you to abandon your plan at the least opportune moment – just as the market is about to recover.

5. What is your tax situation?

A. What percentage of your return from each type of investment income will be lost to taxes each year, including federal and state taxes?

B. How should the differences between state tax rules and federal tax rules be factored into your investment strategy?

C. What types of investment income are most tax-efficient for you?

D. What tax attributes apply to your situation, now or in the near future?

    1. Alternative minimum tax?

    2. Capital loss carry forward?

    3. Charitable deduction carry forward?

The difference in net after-tax performance between a tax-optimized portfolio and one that fails to tax-optimize can be as much as 2% per year over a full market cycle. "Tax-optimization" means that the portfolio is managed using real-time information about your tax situation as it evolves throughout the year. It is very challenging to create systems that are capable of collecting and analyzing tax information throughout the year in a timely manner, and determining how to apply that information to your investment portfolio. Ballentine Partners has spent years creating systems to do this. Most investment advisors don't even attempt it.

6. What legal or policy restrictions do you need to take into account?

IRA, 401(k), 403(b), pension plans and other tax-advantaged accounts are all subject to rules that restrict the types of investments that can be held in these types of accounts. For example, debt-financed investments are not permitted in these accounts.

Many types of trust accounts are prohibited from owning certain types of investments, either because of IRS regulations or because of policy decisions made by the trustee who is responsible for overseeing the account.

Summary

Properly defining your investment goals is a challenging task. Doing it well requires that you have knowledge of:

- Your financial situation and current risk exposures;
- A forecast of your future financial needs, including your plan to withdraw spendable cash from your portfolio;
- Various types of investments, how they behave, and the risk exposures they contain;
- Portfolio construction techniques;
- Taxes that apply to investment income;
- Inflation and its likely impact on your ability to meet your goals;
- Investment fees;
- Your risk-carrying capacity; and
- Legal and other constraints that apply to your life situation.

That is a lot to know! The fact that properly setting investment goals is so challenging probably explains why so many private investors who attempt to do this without expert assistance are unable to stick with a plan and wind up with results that far below what they should have been able to achieve with a more robust plan.

About Roy C. Ballentine, ChFC, CFP®

Roy is the Executive Chairman and Founder of the firm. Roy dedicates his time to thought leadership, strategic oversight of client engagements, and coaching and training our team members.

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info@ballentinepartners.com
https://ballentinepartners.com